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No. ——

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

HOUSTON LIGHTING & POWER COMPANY,
Appellant,

v.

PUBLIC UTILITY COMMISSION OF TEXAS,
Appellee.

On Appeal from the Supreme Court of Texas

JURISDICTIONAL STATEMENT

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QUESTIONS PRESENTED

1. Whether a public utility rate order takes property without just compensation when it gives to ratepayers the benefit of a tax deduction for costs that were not paid by the ratepayers.

2. Whether a state utility commission denies due process of law to a public utility when it bases rates on a determination not made on the ratemaking record.

PARTIES BELOW

The petitioner in the Texas Supreme Court was the Public Utility Commission of Texas. The respondents were Houston Lighting & Power Company, Dow Chemical Company, Diamond Shamrock Company, Texas-New Mexico Power Company, Texas Industrial Energy Consumers, and the Cities of Houston, Lake Jackson, and Friendswood, Texas.

RULE 28.1 STATEMENT

Houston Lighting & Power Company ("HL&P") is a wholly-owned subsidiary of Houston Industries Incorporated, which is a publicly-held company. HL&P has no other publicly-held affiliates or subsidiaries.

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On Appeal from the Supreme Court of Texas

JURISDICTIONAL STATEMENT

OPINIONS BELOW

The opinion of the Texas Supreme Court (Appendix A) is reported at 748 S.W.2d 439. The opinion of the Texas Court of Appeals for the Third Supreme Judicial District (Appendix C) is reported at 715 S.W.2d 98. The opinion of the District Court of Travis County dated September 13, 1984 (Appendix D) is not reported. The order of the Public Utility Commission of Texas dated December 6, 1982, together with the Examiner's Report dated November 9, 1982 (Appendix E), are reported at 50 P.U.R. 4th 157 (1982).

JURISDICTION

The Texas Supreme Court issued its opinion on December 16, 1987, and denied rehearing on May 4, 1988. HL&P filed timely Notice of Appeal in the Texas Supreme Court on July 21, 1988. (Appendix G). This Court has appellate jurisdiction under 28 U.S.C. § 1257 (2). *See Nantahala Power & Light Co. v. Thornburg,*

476 U.S. 953 (1986).[1] Alternately, this Court has jurisdiction under 28 U.S.C. § 1257(3).

CONSTITUTIONAL AND STATUTORY PROVISIONS

The United States Constitution, Amendment V, clause 4:

> [N]or shall private property be taken for public use, without just compensation.

The United States Constitution, Amendment XIV, § 1, clause 3:

> [N]or shall any State deprive any person of . . . property, without due process of law . . . .

The pertinent portions of the Texas Public Utility Regulatory Act, Tex. Rev. Civ. Stat. Ann. art. 1446c, §§ 1-101, are reprinted as Appendices H and I.

STATEMENT OF THE CASE

This is an appeal from a Texas Supreme Court decision that affirmed certain challenged provisions in an order of the Public Utility Commission of Texas (the "PUC") setting rates for Houston Lighting & Power Company ("HL&P").[2] That order gave HL&P's ratepayers the benefits of a tax deduction for $166 million

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[1] On motion for rehearing, the Texas Supreme Court upheld the order of the PUC against HL&P's challenge that the order violates HL&P's rights under the Fifth and Fourteenth Amendments to the United States Constitution. State ratemaking orders issued under delegated legislative authority are "state statutes" for purposes of 28 U.S.C. § 1257(2). *See, e.g., Arkansas Elec. Coop. Corp. v. Arkansas Pub. Serv. Comm'n*, 461 U.S. 375 (1983).

[2] Rate regulation sets rates at a level that allows the regulated utility an opportunity to earn revenues to pay operating expenses and to cover capital costs. That level of revenues typically is defined as:

$$\text{Revenue Requirement} = \text{Operating Expenses} + (\text{Rate Base} \times \text{Weighted Average Cost of Capital})$$

This appeal focuses on the PUC's use of tax benefits arising from costs not included in rates to reduce the amount of tax expense included in rates as an operating expense.

invested in the abandoned Allen's Creek Nuclear Project ("ACNP") even though the order specifically prevented HL&P from recovering the cost of that investment from ratepayers.

HL&P provides electric utility service to 1.3 million customers in Houston and the Gulf Coast area of Texas. In 1972, in an effort to reduce its dependence on expensive fossil fuels and to continue providing low-cost electricity to its customers, HL&P began plans for a two-unit nuclear power plant to be known as the Allen's Creek Nuclear Generating Station. By 1976, turmoil in the nation's economy and energy conservation resulting from four-fold increases in oil prices had reduced HL&P's projections of future growth in the demand for electricity. HL&P therefore decided to cancel one of the generating units in ACNP.

Over the next six years, HL&P continued to reevaluate ACNP in light of more stringent regulatory requirements for nuclear power plant construction, increases in cost estimates for other HL&P construction projects, and concern about the reliability of demand predictions. In August 1982, HL&P concluded that ACNP was no longer economically viable. It therefore abandoned plans for the remaining unit in the project. (App. 4a). By the time of the abandonment, HL&P had invested more than $361 million in engineering studies and plans, legal work, contractual commitments, and site preparation for the project. Given the project-specific nature of a nuclear plant and the preliminary stage of ACNP, HL&P's investment in the project had no significant salvage value.

When ACNP was abandoned, HL&P had pending before the PUC a request for an increase in electric rates. As part of that rate case, HL&P sought to recover from ratepayers the entire cost of the cancelled power plant project.[3] The PUC, acting on the recommendation of a

[3] When a public utility commission allows a utility to recover from ratepayers the costs of a cancelled power plant, those costs are

hearing examiner, denied full recovery. It found that HL&P should have cancelled ACNP no later than January 1, 1980, and that the $166 million spent on the project after 1979 were imprudently invested. The PUC therefore treated the $166 million investment made after 1979 as nonutility property and imposed the entire cost of that investment on HL&P and its shareholders. (App. 136a).

Having denied HL&P recovery of $166 million invested in ACNP, the PUC nevertheless reduced rates by an additional $111 million to account for the federal income tax benefit that the PUC believed HL&P would derive from taking an abandonment loss deduction for that investment. (App. 50a).[4] That rate reduction gave to the ratepayers the value of a tax benefit associated with costs expressly excluded from rate recovery. Since abandoned nuclear plants generally have no salvage value, the PUC's action effectively gave to ratepayers the entire value of nonutility property in which they invested nothing.

In a motion for rehearing before the PUC, HL&P argued that the PUC's order resulted in a confiscation of property in violation of the Texas and the United States Constitutions. HL&P also argued that the PUC had denied

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amortized over a number of years and treated as operating expenses. *See* Rodgers and Gray, *State Commission Treatment of Nuclear Plant Cancellation Costs*, 13 Hofstra L. Rev. 443, 453 (1985); pages 7-8 *infra*.

[4] Neither the PUC's decision nor the hearing examiner's report provides any explanation for the $111 million value that the PUC assigned to the tax benefits at issue. At the 46% corporate income tax rate prevailing in 1982, a $166 million deduction could not generate a tax benefit greater than $76.4 million (*viz.*, $166 million × .46 = $76.36 million). The actual tax benefit available to HL&P from the $166 million investment was even smaller because part of the $166 million capitalized to ACNP under accounting rules represented interest expense that HL&P already had deducted under tax rules. Thus, the $111 million assigned value appears to be grossly overstated by at least $34.6 million.

HL&P due process of law by allocating a tax benefit to ratepayers without any basis in the record for either the allocation or the valuation of the benefit. The PUC summarily denied rehearing without addressing HL&P's constitutional claims. (App. 167a).

On appeal to the District Court of Travis County, HL&P argued that the PUC's order violated the Texas Public Utility Regulatory Act, the Texas Constitution, and the Fourteenth Amendment of the United States Constitution. The District Court found much of the PUC's order (including its treatment of the tax benefits) erroneous on state statutory grounds and remanded the ratemaking proceedings to the commission. (App. 38a-41a). The Court of Appeals for the Third Supreme Judicial District affirmed the District Court's decision.[5] (App. 17a).

The Texas Supreme Court reversed the Court of Appeals. Noting that the abandonment loss deduction for the disallowed investment in ACNP would lower the taxes actually paid by HL&P, the Texas Supreme Court held that all tax savings should pass to the ratepayers. (App. 8a). HL&P moved for rehearing on the grounds that the Supreme Court's decision upholding the PUC's treatment of the tax benefits resulted in a taking of property without just compensation and a denial of due process in violation of the Fifth and Fourteenth Amendments of the United States Constitution. The Texas Supreme Court summarily denied rehearing with one justice dissenting. (App. 10a).

THE QUESTIONS PRESENTED ARE SUBSTANTIAL

I. THIS CASE PRESENTS ISSUES OF NATIONAL SIGNIFICANCE.

The central question in this case is whether a state constitutionally can require the shareholders of a public utility to forfeit tax benefits from their unrecovered in-

[5] The Court of Appeals modified one conclusion not relevant to the issues now on appeal. App. 24a.

vestment in a cancelled power plant. The answer to that question has national significance.

Abrupt changes in our nation's economy have forced electric utilities throughout the country to cancel power plants in which they had invested billions of dollars. In an effort to put the burden of those abandoned projects onto the utilities' shareholders, state utility regulators often prevent utilities from including in their rates all or part of the cost of cancelled plants. The proper allocation between shareholders and ratepayers of the benefits available when part of the disallowed investment is recoverable through federal income tax deductions is a constantly recurring issue. The utility's unrecovered investment generally has no value apart from the tax benefits arising from it. If a state constitutionally can appropriate those tax benefits for ratepayers even though it has denied the utility's shareholders compensation for the use of the property that gives rise to them, then the state will have forced the shareholders to forfeit their entire investment without any compensation. Thus, the Texas Supreme Court's decision in this case has important implications for an industry in which escalating costs and new regulatory risks already have diminished the flow of investment into needed construction.

A. Plant Cancellations.

HL&P's experience with ACNP is typical of the power plant cancellations that have proliferated across the country. The late 1970s and early 1980s saw dramatic escalation in plant construction costs and substantial increases in the regulatory requirements for licensing nuclear plants.[6] At the same time, increases in fuel costs

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[6] Between 1975 and 1980, the cost of a 1,000 megawatt coal-fired plant increased 287% and the cost of a 1,000 megawatt nuclear plant rose 345%. Energy Information Admin., U.S. Dep't of Energy, *Nuclear Plant Cancellations: Causes, Costs and Consequences* 29 (April 1983). Rapid inflation and high interest costs account for much of the increase, but several major and unexpected events had a particular effect on nuclear plants. A 1975 fire at the Tennessee

and fluctuating economic conditions led to energy conservation and decreases in the projected demand for electricity.[7] Electric utilities that had begun new power plants under the conditions of the early 1970s found many of those construction projects to be infeasible under the unexpected, new conditions of the late 1970s and early 1980s. Utilities around the country therefore began to cancel major power plant projects. Between 1977 and 1986, 56 utilities cancelled about 60 plants representing an investment of over $10 billion.[8]

The wave of major plant cancellations has put tremendous pressure on state utility regulators to depart from the accepted regulatory treatment of abandoned investments. Utility rates are the sum of two principal components: operating expenses and a return on rate base. Operating expenses include operating and maintenance expenses, depreciation, taxes, and other expenses incurred to provide utility service to the public. Rate base is a utility's undepreciated investment in the assets used to provide public service.[9] Where a cancelled plant has not gone into service, few state utility regulators have allowed utilities to earn a return on their investment in

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Valley Authority's Browns Ferry nuclear plant and the 1979 accident at the Three Mile Island plant led to the imposition of additional licensing, design, and construction requirements that increased costs and construction time. The average interval required to complete a nuclear plant went from 6.8 years in 1971-74 to 14.4 years for plants completed in 1985. U.S. Dep't of Energy, *Energy Security—A Report to the President of the United States* 189 (March 1987).

[7] Energy Information Admin., *Nuclear Plant Cancellations, supra* note 6, at 7.

[8] *See* Edison Electric Institute, *Regulatory Treatment of Cancelled Plants: Survey and Analysis of Cases* 6-9 (1986) (hereinafter cited as *EEI Survey*); Salomon Brothers, Inc, *Stock Research: Nuclear Construction Utilities* 32-33 (February 1987).

[9] C. Phillips, *The Regulation of Public Utilities* 281 (1984).

cancelled plants by including the cost in rate base.[10] Regulators generally have permitted utilities to recover the investment itself, however, by amortizing the cost as an operating expense item.[11]

State regulators have used two techniques to reduce or mitigate the amortization allowed for the cost of cancelled plants. First, regulators allow no recovery for any part of the utility's investment in the cancelled plant that regulators find to have been imprudent.[12] Second, regulators reduce rate recovery for prudently incurred project costs by the amount of the income tax benefit that the regulators expect the utility to receive from claiming an abandonment loss deduction for those costs.[13] This allocates the tax benefits of the prudent investment to the party bearing the cost of the investment.

In its approach to the plant cancellation costs in this case, the PUC has adopted a radical practice. The commission disallowed the recovery of costs that it found to be imprudent, but it then reduced recovery of the amounts prudently incurred by allocating to ratepayers the tax

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[10] In only about 12 of the more than 94 rate cases involving plant cancellations between 1977 and 1986 did the utility commission allow the cost of the cancelled plant to be included in rate base. *EEI Survey* at 5.

[11] In 67 of the more than 94 rate cases involving plant cancellations between 1977 and 1986, all or part of the cost of the cancelled plant was recovered as an expense. *Id.*

[12] *See, e.g., Washington Util. & Transp. Comm'n v. Pacific Power & Light Co.*, 78 P.U.R.4th 84 (Wash. Util. & Transp. Comm'n 1986); *In re Union Elec. Co.*, 74 P.U.R.4th 80 (Mo. P.S.C. 1986); *In re Maine Pub. Serv. Co.*, 67 P.U.R.4th 101 (Me. P.U.C. 1985); *In re United Illuminating Co.*, 55 P.U.R.4th 252 (Conn. Dep't of Pub. Util. Control 1983); *In re Detroit Edison Co.*, 52 P.U.R.4th 318 (Mich. P.S.C. 1983); *In re Commonwealth Elec. Co.*, 47 P.U.R.4th 229 (Mass. Dep't of Pub. Util. 1982).

[13] *See, e.g., In re Maine Pub. Serv. Co.*, 67 P.U.R.4th 101 (Me. P.U.C. 1985); *In re Central Illinois Light Co.*, 57 P.U.R.4th 351 (Ill. Commerce Comm'n 1983).

benefits associated with the *disallowed* costs.[14] This overlapping combination of the two techniques used by other regulators is a meat axe approach to cutting rates; it simply gives to ratepayers the whole benefit of property in which they invested nothing. In short, this practice gives the ratepayers lower rates than they would have paid had the utility never made the imprudent investment.

The radical practice offered to regulators by the precedent in this case requires the common shareholders of an affected utility to forfeit their unrecovered investment in a cancelled power plant. Given its scope and complexity, most of the work connected with the construction of any major power plant must be tailored to the requirements of the particular site and project. Individual design characteristics and safety requirements make nuclear power plants especially unique. A cancelled nuclear power plant like ACNP therefore has no material salvage value. The only significant value of the investment in the cancelled plant lies in the income tax benefit available from taking an abandonment loss deduction for the capital costs invested in the project.[15]

State regulators reacting to the political furor created by power plant construction already have turned capital

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[14] Vermont's utility regulatory commission addressed a similar practice in *In re Central Vermont Pub. Serv. Corp.*, 86 P.U.R.4th 114 (Vt. P.S.C. 1987).

[15] The Internal Revenue Code specifically allows an abandonment loss deduction for the capital costs of abandoned assets. I.R.C. § 165(a); *see* Treas. Reg. § 1.165-1. The capital costs of an abandoned power plant are simply expenditures that a utility could not deduct for income tax purposes as they were incurred because they related to the construction of the capital asset. *See* I.R.C. § 263(a); Treas. Reg. § 1.263(a)-1. If the plant were completed and put into service, the capital costs would be deducted for tax purposes as depreciation expense over the life of the plant. *See* I.R.C. § 167(a). When the plant instead is abandoned, the capital costs reduced by any salvage value are deductible as a loss because the asset has lost all value to its owner.

intensive utility construction projects into high risk undertakings.[16] If a utility undertakes a large construction project in order to meet projected demand, it faces substantial political and regulatory impediments as well as the very real possibility that some of the project costs will not be recovered.[17] This hostile environment has reduced plant construction to levels that will not meet anticipated national needs. Despite the apparent need for new capacity, only 13,000 megawatts of new generating capacity are planned for 1988. Estimated new capacity in 1989 is only 8000 megawatts, and the estimate for 1990 falls to 2200 megawatts.[18]

The many legitimate impediments to needed power plant construction should not be compounded by illegiti-

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[16] The highly-publicized political battles surrounding Long Island Lighting Company's Shoreham nuclear power plant and Public Service of New Hampshire's Seabrook nuclear plant are pointed, recent examples of this problem. The Department of Energy has noted that:

> The present climate of utility regulation in many states discourages new capital investment, and this restricts the range of new supply options that might otherwise be considered. A fundamental responsibility of a utility regulator is to balance customers' welfare with that of company stockholders; but in recent years the traditional compact in such regulation (which balanced limited risks with limited rewards) has been broken.
>
> . . . .
>
> This asymmetry in risks and rewards to utilities is caused in large part by pressure on regulators to hold down electricity rates near term.

U.S. Dep't of Energy, *Energy Security*, *supra* note 6, at 154-55.

[17] If a utility decides not to construct new generating capacity in order to avoid incurring high construction costs that it expects would be disallowed, the utility faces charges that it has abdicated its public service responsibility. *See, e.g., In re Boston Edison Co.*, Docket No. 85-266A (Mass. Dep't of Pub. Util., June 26, 1986).

[18] *Plant Construction Is Spiraling Down, Says UDI Report*, Electric Light & Power, April 1988, at 36.

mate obstacles erected by state regulators whose decisions have remained largely insulated from federal judicial review. The precedent created in this case would require utilities that undertake plant construction to risk the total loss of their investments in the projects. That new risk arises from an unconstitutional decision that merits this Court's full review.

B. The Need for Supreme Court Action.

This Court is the sole federal forum for constitutional challenges to infirmities in state ratemaking proceedings. The Johnson Act, 28 U.S.C. § 1342 (1982), effectively prevents lower federal courts from reviewing state rate orders. State courts routinely refuse to review constitutional challenges to rate orders by giving a carelessly broad interpretation to the decisions that this Court rendered decades ago in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), and *Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591 (1944).[19] This Court last heard argument on a Fifth Amendment challenge to a state fixed-service rate order almost 50 years ago. *See Driscoll v. Edison Light & Power Co.*, 307 U.S. 104 (1939). State regulatory commissions therefore have operated essentially without constitutional review. *See, e.g., Dayton Power Co. v. Public Utilities Comm'n*, 4 Ohio St. 3d 91, 100, 447 N.E.2d 733, 740 (1983) ("The Constitution no longer provides any special protection for utility investors.")

This Court recently has shown an appreciation for the need to provide state utility regulators with fresh guid-

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[19] *See, e.g., Legislative Util. Consumers' Council v. Public Serv. of N.H.*, 119 N.H. 332, 402 A.2d 626 (1979); *Cleveland Elec. Illum. Co. v. Public Util. Comm'n*, 4 Ohio St. 3d 107, 447 N.E.2d 746 (1983), *appeal denied*, 464 U.S. 802 (1983); *Savannah Elec. & Power Co. v. Public Serv. Comm'n*, 239 Ga. 156, 236 S.E.2d 87 (1977); *Washington Gas Light Co. v. Public Serv. Comm'n*, 450 A.2d 1187 (D.C. 1982); *Application of Hawaiian Tel. Co.*, 67 Haw. 370, 689 P.2d 741 (1984).

ance. Two Terms ago, the Court noted probable jurisdiction in two companion cases where utilities complained of rates so low as to be confiscatory, but a settlement mooted the cases before the Court heard argument. *Kansas Gas & Electric Co. v. State Corporation Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *prob. juris. noted*, 107 S. Ct. 1281, *appeal dismissed*, 107 S. Ct. 2171 (1987); *Kansas City Power & Light Co. v. State Corporation Comm'n*, 232 Kan. 483, 720 P.2d 1063 (1986), *prob. juris. noted*, 107 S. Ct. 1281, *appeal dismissed*, 107 S. Ct. 3280 (1987). This Term, the Court will hear argument in *Duquesne Light Co. v. Barasch*, No. 87-1160, on the constitutionality of a state statute that entirely excludes the cost of cancelled power plants from utility rate recovery. *Barasch v. Pennsylvania Public Utility Comm'n*, 516 Pa. 142, 532 A.2d 325 (1987), *prob. juris. noted sub nom. Duquesne Light Co. v. Barasch*, 108 S. Ct. 1105 (1988). The present case poses the related, but more fundamental question whether the value of property excluded from rate recovery nevertheless can be appropriated for the benefit of ratepayers. No matter how the Court decides the *Duquesne* case, the further question presented here will have far-reaching significance for the utility industry.

II. THE USE OF TAX BENEFITS FROM NONUTILITY PROPERTY TO REDUCE UTILITY RATES IS AN UNCONSTITUTIONAL TAKING.

The issue in this case is not whether the rates set by the PUC are adequate to compensate HL&P for property dedicated to public service. The issue is whether the PUC can reduce adequate rates in order to award ratepayers the benefit of a tax deduction associated with property not dedicated to public utility service. Thus, the standard of review found in *Federal Power Comm'n v. Hope Natural Gas Co.*, *supra*, for public utility rates challenged as inadequate under the Fifth Amendment does not apply here. *Hope* and its progeny establish that a court need

not inquire deeply into ratemaking methods if the rates set as the end result of the ratemaking proceeding provide constitutionally adequate compensation for the utility property devoted to public service. *See Hope*, 320 U.S. at 602-03. That standard of review does not apply where the state has appropriated the value of nonutility property and used it to reduce rates for the public use of utility property.

Since this case involves a taking of nonutility property rather than the reasonableness of compensation for the use of utility property, traditional Fifth Amendment principles must govern. The PUC cannot use *Hope* as a screen behind which to confiscate nonutility property. If the PUC could justify the appropriation of nonutility property by arguing that the rates nevertheless provide a reasonable return on property dedicated to public service, then the latitude given to utility regulators by *Hope* and its progeny would become a license to seize private property without just compensation.

A. HL&P's Disallowed Investment in ACNP Is Not Public Utility Property.

In this case, the PUC found that $166 million spent for ACNP were not a prudent utility investment. It disallowed any rate recovery for that investment. The PUC's decision classified the property rights attributable to the disallowed investment in ACNP, including the tax benefits, as nonutility property. The public would pay nothing for that property. Following the PUC's determination, the public had no further claim to the property. For the PUC nevertheless to appropriate all tax benefits from the property for the benefit of ratepayers is a taking of property without any compensation.

A public utility has a duty to provide adequate service to the public and a right to receive just compensation for

the service provided.[20] A utility therefore invests capital to serve the public's needs with the legitimate expectation that it will receive adequate compensation for all capital properly dedicated to the public's use.[21] Utility regulators must determine whether particular investments are reasonable and appropriately serve the public.[22] If the regulators decide that all or part of certain investments are not reasonable, they disallow the recovery from ratepayers of the inappropriate costs. The disallowance of inappropriate costs is a refusal to accept the dedication to public use of the property represented by those costs. The disallowed costs are not public utility expenditures, and the related investment is not public utility property. C. Phillips, *The Regulation of Public Utilities* 195 (1984).

Texas, like other states, recognizes the distinction between utility and nonutility property.[23] The Texas Pub-

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[20] *See Board of Pub. Util. Comm'rs v. New York Tel. Co.*, 270 U.S. 23, 31 (1926); *see, e.g.*, Tex. Rev. Civ. Stat. Ann. art. 1446a, §§ 35(a), 39 (Vernon Supp. 1988).

[21] *See Federal Power Comm'n v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944); *Missouri ex rel. Southwestern Bell Tel. Co. v. Pub. Serv. Comm'n*, 262 U.S. 276, 290-91 (1923) (Brandeis, J., concurring).

[22] *See Mississippi River Fuel Corp. v. Federal Power Comm'n*, 163 F.2d 433, 437 (D.C. Cir. 1947). *See also* Phillips, *Regulation of Public Utilities, supra* note 9, at 223.

[23] *Federal Power Comm'n v. United Gas Pipe Line Co.*, 386 U.S. 237 (1967), on which the Texas Supreme Court relied in this case, also recognized the distinction between utility and nonutility property in its resolution of a statutory issue under the Natural Gas Act, 15 U.S.C. §§ 717 *et seq.* (1982). 386 U.S. at 243. *United Gas* dealt with the treatment of tax benefits from the operating losses of companies not regulated under the Act that filed consolidated tax returns with regulated companies. The tax benefits at issue were not attributes of particular capital assets, and the parties did not raise the constitutional issue presented by this case. *See also Charlottesville v. Federal Energy Regulatory Comm'n*, 774 F.2d 1205 (D.C. Cir. 1985), *cert. denied*, 475 U.S. 1108 (1986).

lic Utility Regulatory Act provides for rates that allow a public utility to recover prudently incurred operating expenses and a fair return on amounts prudently invested in property needed to render utility service. Tex. Rev. Civ. Stat. Ann. art. 1446c, § 39(a) (Vernon Supp. 1988); *see Railroad Comm'n v. High Plains Natural Gas Co.*, 628 S.W.2d 753 (Tex. 1981). Rates set under the Texas statute do not compensate a utility for property that the PUC finds not to be used and useful in the provision of public utility service. Tex. Rev. Civ. Stat. Ann. art. 1446c, § 40(a). Rates set under the statute also do not allow for the recovery of expenses incurred imprudently. *Id.* § 41(c)(3). Disallowed items are not public utility property; the utility's shareholders bear the entire cost of disallowed items. *Suburban Utility Corp. v. Public Utility Comm'n*, 652 S.W.2d 358 (Tex. 1983).

The distinction between utility and nonutility property recognized by state law responds to constitutional necessity. Under the Fifth Amendment, the public must pay for the utility property that it uses. *Permian Basin Area Rate Cases*, 390 U.S. 747, 770 (1968); *Bluefield Waterworks & Improvement Co. v. Public Service Comm'n*, 262 U.S. 679, 690 (1923). The public need not pay, however, for property that it does not use. *Acker v. United States*, 298 U.S. 426, 430-31 (1935); *West Ohio Gas Co. v. Public Utilities Comm'n*, 294 U.S. 63, 68 (1935); *see also Missouri ex rel. Southwestern Bell Telephone Co. v. Public Service Comm'n*, 262 U.S. 276, 290 n. 1 (1923) (Brandeis, J., concurring). Utility regulators operating under state law determine whether particular investments fall into one category or the other. The regulatory determination that property is utility property asserts the public's right to use that property; the determination that other property is nonutility property releases that property from the public's claims.

Where a utility commission takes the value of nonutility property in order to reduce utility rates, as the

PUC has done here, the standard of review announced in *Hope*, 320 U.S. at 602-03, cannot protect utility shareholders' constitutional rights. Since something more than utility property has been appropriated, rates that provide a fair return on utility property alone obviously are not adequate. By finding the property in question to be nonutility property, the utility commission has denied the utility any compensation for taking it.

The constitutionality of utility regulation that takes nonutility property must be tested under traditional Fifth Amendment principles. This Court applied that standard of review in *Brooks-Scanlon Co. v. Railroad Comm'n*, 251 U.S. 396 (1920). In *Brooks-Scanlon*, a state railroad commission had refused to allow a timber company to abandon an unprofitable railroad operation on the ground that the company's nonutility operations generated sufficient income for the company to make a profit notwithstanding the loss from the railroad. This Court used ordinary Fifth Amendment standards flatly to reject the view that benefits from nonutility property could be taken to reduce utility rates. *Id.* at 399.

B. The PUC Confiscated HL&P's Disallowed Investment in ACNP.

The principle that utility regulators may not take nonutility property in order to subsidize utility rates is indisputable. Indeed, American public utility regulation rests upon that bedrock understanding.[24] The question in a particular case, of course, is whether the regulatory treatment there at issue constitutes a taking. The magisterial answer to that question announced by Justice Holmes in *Brooks-Scanlon* may provide little guidance in complex modern cases, but this Court's recent Fifth Amendment decisions strongly support the conclusion

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[24] *See, e.g., Northern Pac. Ry. v. North Dakota*, 236 U.S. 585 (1915); *Munn v. Illinois*, 94 U.S. 113 (1877).

that the PUC's action in this case unconstitutionally deprives HL&P of its property without just compensation.

Although this Court's recent Fifth Amendment decisions have been the product of "essentially ad hoc, factual inquiries," those decisions have emphasized the significance of three factors in determining whether the "economic injuries caused by public action" constitute a taking for which compensation is required. *Kaiser Aetna v. United States*, 444 U.S. 164, 175 (1979). Those factors are (i) the character of the governmental action, (ii) the economic impact of the regulation, and (iii) the interference with reasonable investment-backed expectations. *Id.* No factor necessarily carries greater weight than another, but a single factor can be dispositive in a given case. *See, e.g., Hodel v. Irving*, 107 S. Ct. 2076, 2083 (1987) (character of governmental action dispositive); *Ruckelshaus v. Monsanto Co.*, 467 U.S. 986, 1005 (1984) (interference with investment-backed expectations dispositive). The PUC's action in this case is unconstitutional under each of the three factors, and its interference with legitimate investment-backed expectations is palpable.

The character of the governmental action in this case is extraordinary. Behind the screen of a ratemaking proceeding, the PUC has seized for the public the value of property that the PUC itself expressly excluded from the scope of the proceeding. After excluding HL&P's $166 million investment from rates, the PUC nevertheless reduced rates in order to give ratepayers the $111 million value imputed to the tax attributes of the investment. "No police power justification is offered for the deprivation." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. 155, 163 (1980). The PUC simply used the appropriated property to reduce rates that it had determined to be reasonable. Such a "forced contribution" to the public without any substantial justification related to the public health and safety violates the Fifth

Amendment. *Id.; see Connolly v. Pension Benefit Guaranty Corp.*, 106 S. Ct. 1018, 1027 (1986); *Armstrong v. United States*, 364 U.S. 40, 49 (1960).

The PUC's action has substantial economic impact. The PUC valued the property that it took at $111 million. More importantly, the taking is virtually complete. The possible tax benefit from deducting the abandonment loss represents virtually all of the value realizable from HL&P's $166 million investment. The PUC took that remaining value for ratepayers without compensation. A taking of such totality not closely tied to the accomplishment of a vital public purpose is unprecedented and unjustified. *See Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S. Ct. 1232 (1987) (vital public interest in preventing surface subsidence justified taking); *Miller v. Schoene*, 276 U.S. 272 (1928) (vital public interest in arresting plant disease justified taking).

The PUC's appropriation of tax benefits from nonutility property manifestly interferes with the legitimate, investment-backed expectations of the utility shareholders who bear the entire cost of HL&P's disallowed investment in ACNP. Utility investors legitimately expect that the utility will receive compensation for property dedicated to public use. Although they take the risk, particularly in the regulatory environment of the 1980s, that certain investments may be disallowed, the investors also legitimately expect that losses from disallowances will be mitigated by certain tax benefits.

The right to claim a tax deduction for the loss of an abandoned construction project, which has been appropriated in this case, is more than a "unilateral expectation or an abstract need." *Webb's Fabulous Pharmacies, Inc. v. Beckwith*, 449 U.S. at 161. It is a right established by federal statute.[25] Since the availability of tax

[25] Section 165 of the Internal Revenue Code gives taxpayers the right to claim abandonment loss deductions. *See supra* note 15.

benefits to mitigate project losses directly affects an investor's decision about the desirability of the investment, the PUC's appropriation of such benefits cuts as deeply into legitimate investment-backed expectations as the governmental disclosure of trade secrets found to be unconstitutional in *Ruckelshaus v. Monsanto Co.*, 467 U.S. at 1005. Here, as in *Monsanto*, that interference by itself is serious enough to make the governmental action a violation of the Fifth Amendment.

The tax benefit appropriated by the PUC is essentially the only valuable property right recoverable from HL&P's nonutility investment in ACNP. The PUC's decision to take the benefit strips the investment of any meaningful value. Instead of a tax benefit that the PUC estimated at $111 million, the $166 million investment now can yield its owner no more than minimal salvage. In fact, by overstating the potential tax benefit,[26] the PUC's order actually appears to have appropriated more than the entire value of HLP&'s investment at the time of the taking.

State action that strips private property of all material value to its owner effects a taking of property for which compensation is required. *Ruckelshaus v. Monsanto Co.*, 467 U.S. at 1004-05 (citing *United States v. General Motors Corp.*, 323 U.S. 373, 378 (1945)). While this Court has found that state regulation may deny a property owner certain rights to the beneficial use and exploitation of his property, *see, e.g., Keystone Bituminous Coal Ass'n v. DeBenedictis*, 107 S. Ct. 1232 (1987), regulation that renders property useless to the private owner cannot be sustained unless the state provides just compensation. *See Hodel v. Irving*, 107 S. Ct. at 2084; *Agins*

Legitimate expectations created by statute are property rights entitled to protection under the Fifth and Fourteenth Amendments. *See, e.g., Mathews v. Eldridge*, 424 U.S. 319, 332 (1976); *Armstrong v. United States*, 344 U.S. 40, 44 (1960).

[26] *See supra* note 4.

v. Tiburon, 447 U.S. 255, 260-61 (1980); *Penn Central Transportation Co. v. New York*, 438 U.S. 104, 127-28 (1978). The PUC's order in this case steps well beyond the boundary drawn by the Fifth Amendment. At best, the order forces HL&P to forfeit all material value of its nonutility investment in ACNP. In fact, the order appears to take even more than the value of the investment put at issue in the case.

III. A RATEMAKING DETERMINATION MADE WITHOUT ANY BASIS IN THE RECORD IS A DENIAL OF DUE PROCESS.

This Court long has recognized that a regulatory order lacking any basis in the regulatory record is arbitrary and a denial of the due process guaranteed by the Fourteenth Amendment. *Northern Pacific Railway v. Department of Public Works*, 268 U.S. 39, 44-45 (1925); *Interstate Commerce Comm'n v. Louisville & Nashville Railroad*, 227 U.S. 88 (1913). The Due Process Clause also requires regulators to give affected parties sufficient "opportunity through evidence and argument to challenge the result" of the agency order. *Railroad Comm'n v. Pacific Gas & Electric Co.*, 302 U.S. 388, 393 (1938). Without notice and an opportunity to be heard, parties subject to regulation are deprived of a fair opportunity to protect their property from arbitrary state action. *See Fuentes v. Shevin*, 407 U.S. 67, 80-81 (1972).[27] Without a record that discloses the grounds for the regulatory decision and the essential facts upon which that decision is based, courts cannot interdict arbitrary decisions. *See Dunlop v. Bachowski*, 421 U.S. 560, 574 (1975).[28]

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[27] *See also Federal Radio Comm'n v. Nelson Bros. Bond & Mortgage Co.*, 289 U.S. 266, 277 (1933) (a finding without substantial evidence to support it is an arbitrary or capricious finding); *The Chicago Junction Case*, 264 U.S. 258, 265 (1924) (to make an essential finding without supporting evidence is arbitrary).

[28] Both federal and state statutes have codified these constitutional requirements. *See, e.g.*, Administrative Procedure Act, 5

In this case, the PUC gave no notice of its intention to allocate to ratepayers the tax benefits associated with HL&P's disallowed investment in ACNP. The hearing examiner's report to the PUC contains no discussion of tax benefits because the issue simply was not raised or discussed in the agency hearing. Even if the PUC had some basis for allocating the tax benefits to ratepayers, the record contains no evidence about how the benefits were calculated. Indeed, whatever assumptions the PUC used to make its calculations in this case patently were wrong.[29] A manifestly incorrect decision made without any basis in the ratemaking record is arbitrary and a denial of HL&P's right to due process.

U.S.C. §§ 551 *et seq.* (1982); Texas Administrative Procedure Act, Tex. Rev. Civ. Stat. Ann. art. 6252-13a *et seq.* (Vernon Supp. 1988). This Court has held that the Federal Administrative Procedure Act creates "safeguards even narrower than the constitutional ones, against arbitrary official encroachment of private rights." *United States v. Morton Salt Co.*, 338 U.S. 632, 644 (1950).

[29] *See supra* note 4.

CONCLUSION

The Court should note probable jurisdiction and set this case for argument. In an increasingly complex utility industry, the constitutional issues posed by rate-making are difficult and important. The state regulators of electric utilities are sorely in need of guidance. This Court should reverse the Texas Supreme Court's decision and remand the case with instructions to set rates that contain no reduction for any tax benefit realizable from disallowed investment.

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